

Sustainable Finance Disclosure Regulation - Article 9 Funds or “Dark Green Funds”

What to consider for Article 9 Funds based on the draft regulatory technical standard issued by the European Supervisory Authorities (“ESAs”) on 4 February 2021?

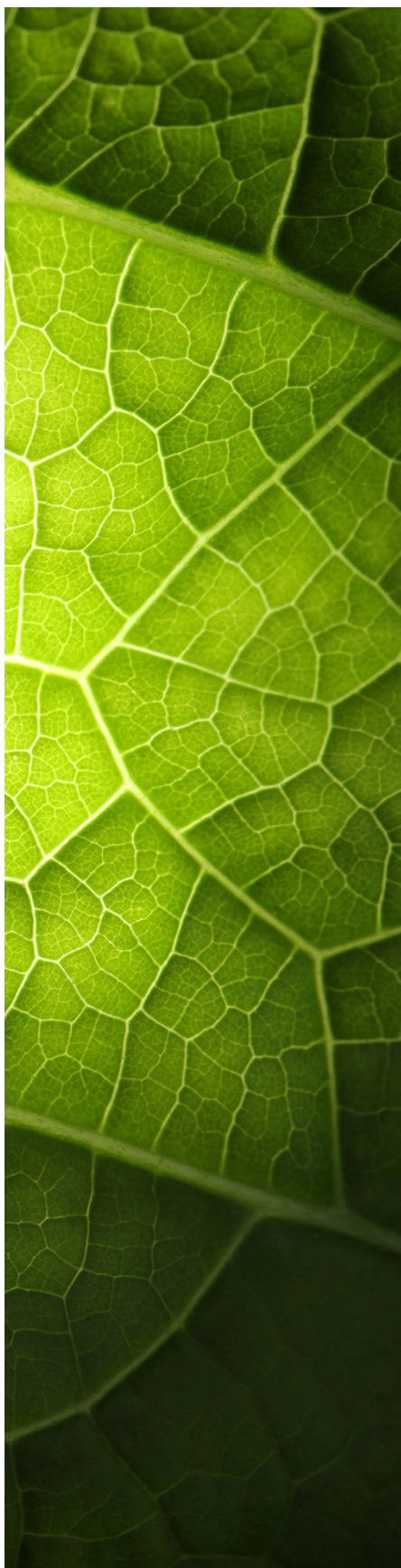
The second part of our Sustainable Finance Disclosure Regulation (“SFDR”) update focused on the key considerations for [Article 8 Funds](#). Some of the key highlights included:

- **Scope** – If a Fund considers the principal adverse sustainability impacts (“PASIs”) indicators this does not mean that the Fund is automatically an Article 8 Fund. The Fund Manager must integrate the PASIs indicators into their investment decisions.
- **PASI** – [The draft regulatory technical standards \(“Draft RTS”\)](#) addressed some of the feedback from the industry by reducing the number of mandatory PASIs from 32 to 14, that Fund Managers and Funds are expected to monitor

and report against. The changes in respect of investments in sovereigns, supnationals and real estate assets are a particularly welcome change, due to the unique nature of these investments. PASI indicators should be assessed quarterly e.g. For 31 December year ends the calculation should be performed in March, June, September and December. This allows for a yearly average to be calculated providing a representative PASI for the reporting period which should be easier for Funds that have significant portfolio turnover. The PASI should be completed for at least the 5 previous reporting periods. There is no requirement to calculate the PASI retrospectively.

- **Disclosures and reporting** – The new mandatory templates for pre-contractual and periodic reporting disclosures allow for consistency in reporting across Funds.
- **Assurance over non-financial information** – The benefits of assurance improve transparency and credibility of non-financial information, resulting in a higher level of trust from potential investors.

The areas above are applicable for all Article 8 and 9 Funds. In this paper we will focus on the **additional** requirements for Article 9 Funds.



Scope

An Article 9 Fund under SFDR is defined as *“a Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective.”*

There are a number of different requirements for Funds that promote a sustainable investment objective. These requirements include:

- An Article 9 Fund will have to incorporate good governance into the investment strategy i.e. assessment of sound management structures, employee relations, remuneration and tax for the underlying investments. Similarly an Article 8 Fund that promotes a sustainable investment objective will have to incorporate the good governance criteria and this has been confirmed by the ESA’s as expected.
- In addition, an Article 9 Fund is required to assess the Fund portfolio against the principle of “do no significant harm” by considering the PASIs, and incorporating considerations of the minimum social safeguards specified in the [Taxonomy Regulation \(Regulation \(EU\) 2020/852\)](#) on the establishment of a framework to facilitate sustainable investment. We expect this will entail additional work on the risk assessment against social safeguards for Fund Managers seeking to offer Article 9 Funds.
- In the Draft RTS, Article 9 Funds with a carbon reduction objective must refer to an EU Climate Transition Benchmark or an EU Paris-aligned Benchmark (once available). The ESA’s have written a [letter](#) to the European Commission to clarify whether this requirement to track the benchmarks on a passive basis will be required. At the date of publication of this article the European Commission has not clarified this point.



Deloitte’s view:

Article 9 Funds will have to align to a least one of the Taxonomy criteria and do no significant harm to the others. Any Article 9 Funds with a carbon reduction objective will potentially have to track an EU Climate Transition Benchmark or an EU Paris-aligned Benchmark. We expect this will entail more work for Fund Managers to do a risk assessment in setting up the Fund, to consider if it really is an Article 9 Fund.

Market Overview for Article 9 Funds

Although the investment industry is still adjusting to the measures and uncertainties remain about classifying funds as Article 9, Morningstar has started collecting data from fund prospectuses (about 15,000 funds or 52% of the European Market). Based on preliminary data, Morningstar estimates that funds classified as Article 9 currently represent up to 2.7% of total European fund assets. By extrapolating the current data the European sustainable fund market, based on SFDR definitions, could be worth as much as €2.5 trillion and €0.3 trillion for Article 9 Funds. Irish Funds has recently performed a survey with the law firms based on SFDR offering documents filed with the Central Bank of Ireland as of the 10 March 2021. Based on the survey 2%¹ or 127 funds domiciled in Ireland are classified as Article 9 Funds which reflects the current state of play in the market and the high bar in terms of sustainable investment that Article 9 Funds need to achieve.

2021 began where 2020 left off with European investors continuing to pour money into sustainable funds. The steady first-quarter inflows were driven by continued investor interest in ESG issues, especially in the wake of the Covid-19 crisis. The disruption caused by the pandemic has highlighted the importance of building sustainable and resilient business models based on multi-stakeholder considerations. More investors are looking to promote more sustainable practices and products, while others are looking to future-proof their portfolios against climate risk. Climate funds were once more among the best-selling funds in Q1 2021, with six of them featuring among the top 10². In the first quarter of 2021 there were 111 sustainable funds launched similar to the prior year and we are expecting this growth to continue.



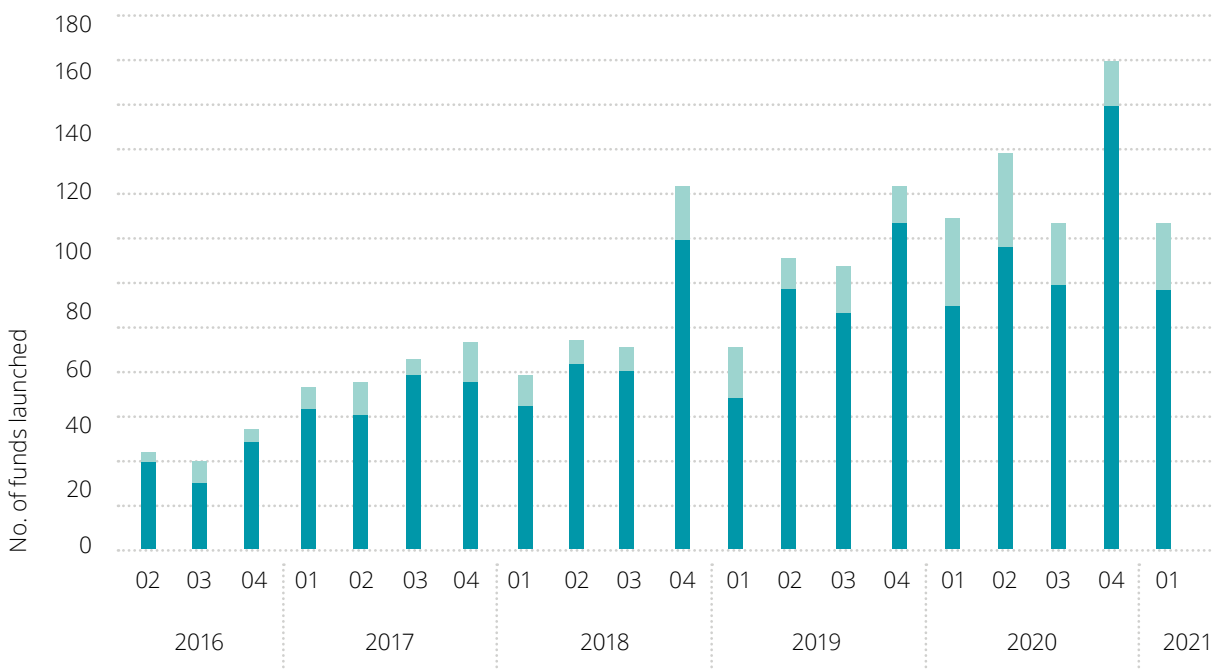
Deloitte's view:

We expect sustainable funds to continue to be in demand in 2021.

Fund Managers need to see SFDR as an opportunity to garner new assets given the growth and flows towards sustainable funds.

Sustainable funds will be a requirement for all asset owners in deploying capital in the near future.

Exhibit 3: European Sustainable Fund Launches Per Quarter



Source: Morningstar Direct Morningstar Research, Data as of March 2021.

■ Active ■ Passive

- Survey based on SFDR offering document filings to the Central Bank of Ireland as of 10 March 2021. 15 legal firms surveyed with a response rate of 100%. Two firms did not return fund numbers under the "Other Funds" category. In these cases, the number of "Other Funds" was calculated based on data from the Monterey Insight Ireland Fund Report, as of June 2020. Total number of funds excludes certain funds deemed out of scope, e.g. funds closed to new subscriptions, dormant funds, etc.
- <https://www.morningstar.co.uk/uk/news/211923/sustainable-fund-flows-hit-new-record.aspx>

Disclosures and reporting

The Draft RTS has now included mandatory templates (Annexes III and V) for PASI reporting for pre-contractual disclosures and periodic reporting for Article 9 Funds. In accordance with Article 2 of the Draft RTS some general principles for the presentation of information on the PASI disclosures include:

- The information is easily accessible, non-discriminatory, free of charge, prominent, simple, concise, comprehensible, fair, clear and not misleading.
- Must be in a searchable electronic format except where the manner referred to in Articles 6(3) and 11(2) of SFDR requires the information to be provided on paper.
- The information shall be published on the websites and kept up to date.
- Legal entity identifiers should be provided when referring to investee companies.

Product Level Pre Contractual Disclosures – Annex III Draft RTS

For Article 9 Funds, Annex III in the Draft RTS is the template to be used for disclosure in pre contractual documents. In the pre contract document the Fund needs to include a statement at the beginning of the Annex to explain the following:

- a) That the Fund has a sustainable investment objective; and
- b) The details of any index that has been designated as a reference benchmark.

The statement should be a summary and include the following sections:

- The sustainable investment objective pursued by the Fund;
- The investment strategy followed by the Fund, including its Article 9 objective;
- The planned asset allocation for the Fund in terms of sustainable investments versus non-sustainable;

- A statement that the Fund considers the PASI;
- Link to website Fund disclosures;
- How any reference benchmarks are aligned with the sustainable investment objective;
- How the designated index aligned with that objective differs from a broad market index;
- For Article 9(3) Funds (whose objective is a reduction in carbon emissions) disclosures against the Climate Transition or Paris-aligned Benchmarks used by the product, or where they are not available, the underlying methodologies; and
- Article 9(3) Funds shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.





Product-level website disclosures

The website disclosures for Article 9 Funds must include the following:

- Summary;
- Explanation of how the investments of the Fund does no significant harm to the sustainable investment objective;
- Sustainable investment objective of the Fund;
- Investment strategy pursued including to meet sustainable investment objective;
- Proportion of investments in sustainable and non-sustainable assets;
- Monitoring of sustainable investment objective;
- Methodologies used to assess and monitor sustainable investment objective;
- Data sources and processing;
- Limitations to methodology and data;
- Due diligence done on underlying assets regarding sustainable investment criteria;
- Engagement policies;
- Attainment of sustainable investment objective through the use of any reference benchmarks.

Product-level periodic disclosures – Annex V Draft RTS

For Article 9 Funds, Annex V in the Draft RTS is the template to be used for periodic disclosure in the annual report. The following is included in the disclosure template:

- The extent to which the sustainable investment objective of the Fund was met during the reference period;
- The top investments of the Fund;
- The proportion of sustainable investments versus non-sustainable;
- Actions taken to attain the sustainable investment objective during the reference period;
- For a Fund that tracks a reference benchmark, a summary of how the product performed compared to the reference benchmark; and
- For a Fund with carbon emissions reduction as its sustainable objective, a summary of how this aligned with the Paris Agreement.

Deloitte's view:

For Article 9 Funds that track a reference benchmark, the Fund must provide a summary of how it compared to the benchmark in performance and sustainability indicators i.e. any sustainability indicators deemed relevant by the Fund Manager to determine alignment of the benchmark with the sustainable investment objective including any ESG factors referred to in the benchmark. This could be presented in a table format in addition to the other disclosures required.

For Article 9 Funds that have an objective for a reduction in carbon emissions, the Funds will have to disclose the reduction in carbon emission to achieve the target set in the Paris Climate Agreement which is 40% by 2030.



Timeline

As we approach the end of Q2 2021 it is expected that the final RTS will be approved by the European Commission. Fund Managers need to start putting in place processes and procedures to capture, monitor and report the information required under SFDR. The next few key milestones include:

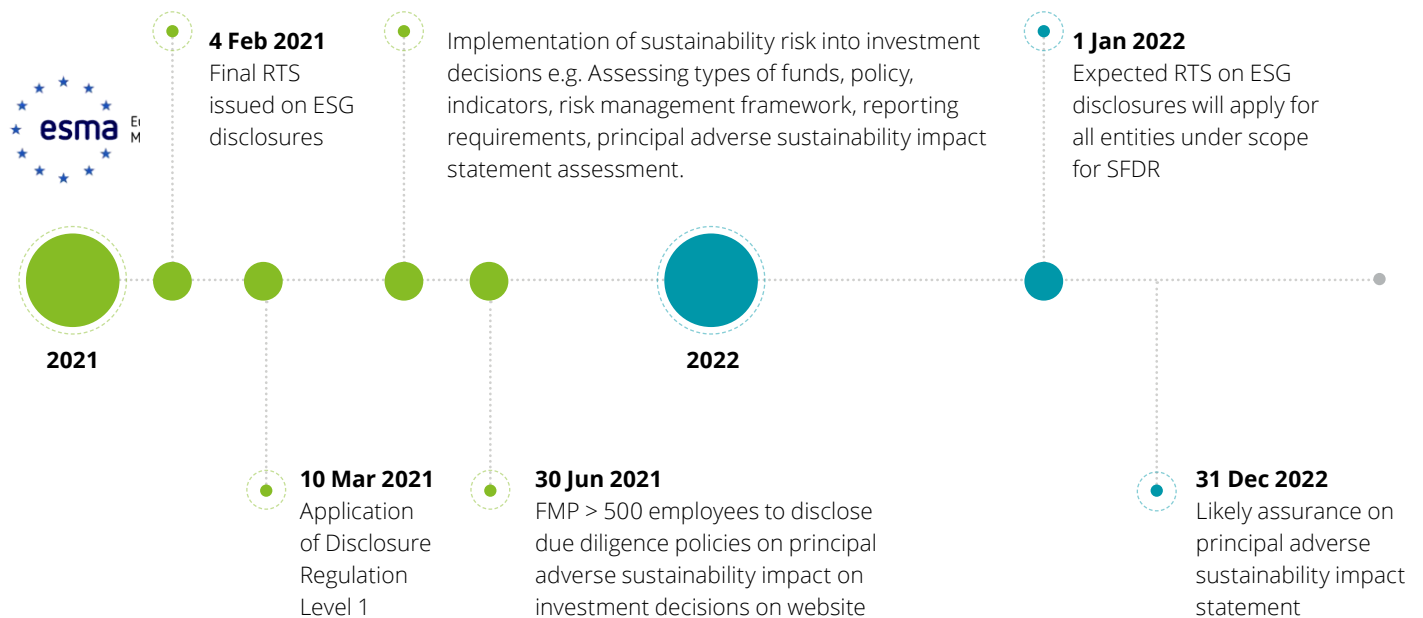
- 30 June 2021 – For any large Fund Managers i.e. >500 employees they will have to start disclosing due

diligence policies on principal adverse sustainability impact on investment decisions on their website. The Fund Manager should consider the PASI indicators in the Draft RTS in doing this assessment.

- 1 January 2022 – it is expected that the pre contractual documents will have to be updated to include the PASI indicators and the Fund Manager and Funds will have to start monitoring the PASI for periodic reporting.

- 31 December 2022 – For Funds with financial period 1 January to 31 December, Funds will have to disclose the PASI indicators in the annual report.
- 1 January 2023 – If assurance is obtained, the controls and process for capturing, monitoring and reporting the PASI indicators will be completed along with the financial statement audit.

Timeline of key milestones



Deloitte's view:

In order for Fund Managers and Funds to be ready to report on the PASI indicators from 1 January 2022, Fund Managers will have put in place controls and processes to capture, monitor and report the data. This includes integrating the PASI into the governance structure, risk framework and reporting to the board of directors. This will need to be completed before the end of 2021 in order for Fund Managers and Funds to be ready.



Assurance over non-financial information

As the information disclosed will be used by stakeholders to make investment decisions, any assurance provided over this information will provide stakeholders with greater confidence over the reporting of the disclosures. In the draft RTS the ESA's have noted that if any sustainability indicators have been assured by an auditor or third party that they are clearly identified.

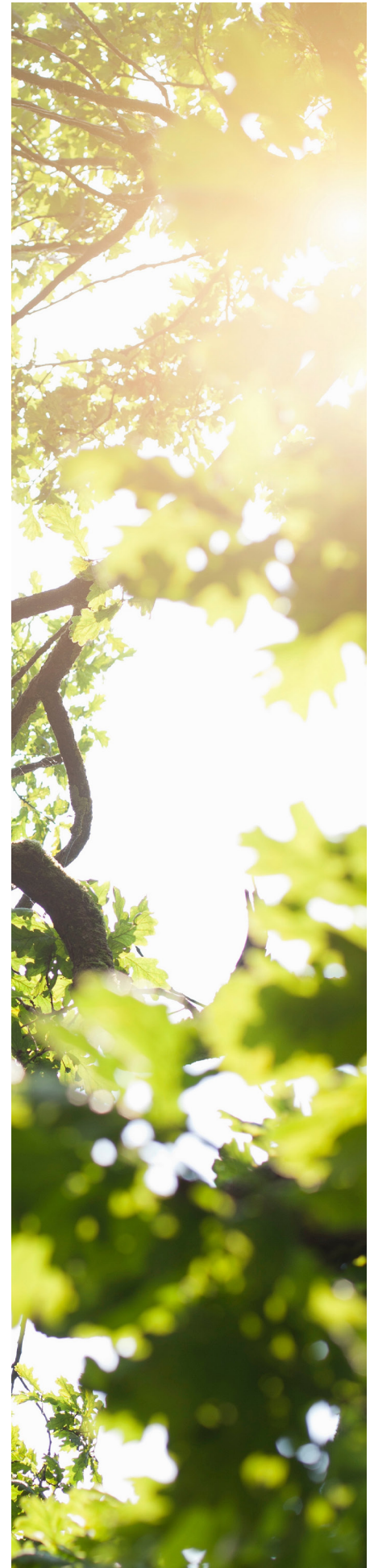
The benefits of assurance over non-financial information include:

- Improved transparency and credibility of non-financial information, resulting in a higher level of trust of potential investors;
- Increased business opportunities for becoming a part of reliable supply chains, due to improved capabilities;
- Improved engagement from board of directors and the Fund Manager;
- Improved internal reporting and management systems;
- Improved communication with stakeholders; and
- Reduced risk and increased value.

Deloitte can support Fund Managers in getting ready for the detail requirements of SFDR. Our approach is to perform a readiness assessment or advise Fund Managers on what is required to report information on SFDR. This will lead to reporting capabilities that can be assured by an auditor.

Deloitte's view:

As the regulators continue to harmonise the reporting requirements for sustainability information it will only be a matter of time before the audit regulators bring out a specific standard to address the sustainability reporting frameworks. The type of assurance that can be provided to date over sustainability reporting is largely limited assurance but this will progress to reasonable assurance as the data becomes more consistent, comparable and transparent. The proposed [Corporate Sustainability Reporting Directive](#) will increase the level of assurance in the future.





How can Deloitte Help

We have designed a framework to support sustainability risk integration and the provision of assurance over your ESG disclosures that can support boards of directors, audit committees and management in their journey towards compliance with SFDR disclosure requirements or other ESG frameworks.

Product and innovation

What is it:

Product feasibility study

What is it used for:

Focusing on concept, market, criteria and impact assessment within regulatory guidelines.

Benchmarking and gap analysis

What is it:

Independent benchmarking of your current disclosures against recommendations and/or identifying gaps in your disclosures, processes or controls and reporting privately to management and those charged with governance.

What is it used for:

Benchmarking and gap analysis provides the basis of a roadmap to ESG disclosures.

Designing and Implementing ESG frameworks

What is it:

Designing and implementing a policy and risk management framework that captures processes, controls and reporting privately to management and those charged with governance on the ESG integration.

What is it used for:

Policy and framework can be used to monitor ESG for all investment products.

Assurance over selected ESG metrics

What is it:

Private or public independent ISAE 3000 assurance over your ESG disclosures and metrics.

What is it used for:

Assurance over ESG disclosures and metrics can be a useful starting point on a path to SFDR disclosure compliance or provide investors with confidence you have integrated sustainability risk into investment decisions.

Contacts

For more information please contact:



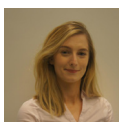
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